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# BARRIERS TO FINANCIAL REFORM

By

Robert C. Vogel

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Agricultural Finance Program
Department of Agricultural Economics and Rural Sociology
2120 Fyffe Road
Columbus, Ohio 43210

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Robert C. Vogel*

There seems to be widespread agreement, at least among most academic economists and technical advisers, that programs of financial reform would be beneficial for rural financial markets in developing countries and, furthermore, that the key element in any program of financial reform is interest rates which are at least positive in real terms. The purpose of the present paper is not to reiterate the many well known arguments against subsidized low interest rates and in favor of interest rates which are closely tied to the levels that would be determined in competitive markets, but rather to ask why so little progress has been made in achieving reform in rural financial markets. There are, to be sure, a few developing countries which have initiated, and even maintained, programs of financial reform. However, many of the examples of higher interest rates which are often cited as signs of progress toward financial reform are in fact inadequate even to keep pace with the higher rates of inflation that have afflicted most developing countries in the 1970's.

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* Professor of Economics, Syracuse University, and Visiting Professor of Agricultural Economics, Ohio State University

The lack of progress in reforming rural financial markets may simply be due to lack of information; that is, the arguments in favor of financial reform have not yet been made with sufficient clarity and force to convince the key policy makers in developing countries of the need for change. However, in the present paper it is assumed that lack of progress is not due simply to lack of information, and there are a number of reasons which can be given to support this view. Not only is there a growing literature which convincingly argues the merits of financial reform, much of it in a form which can readily be understood by policy makers, but there is also the direct contact between policy makers in developing countries and technical advisers who appear to be increasingly willing to offer recommendations which involve substantial doses of financial reform. The fact that international lending institutions continue to support projects which fail to contain even small doses of financial reform does not mean that the employees and technical advisers of these institutions do not appreciate the advantages of financial reform, but rather indicates the depth of the opposition in developing countries to reforming rural financial markets.

The present paper examines the source of this opposition to financial reform and, in particular, four types of arguments which have been raised not against financial reform *per se* but against the possibility of actually carrying out a successful program of financial reform in a typical developing country. These arguments do not necessarily deny the potential benefits of financial reform in the abstract, nor do they exhaust the arguments against financial reform, and some observers may even think that the most common or the most forceful arguments against financial reform have not been considered. Nonetheless, these arguments do illustrate the substantial barriers that must be overcome in order to carry out a reform of rural financial markets even after the advantages of financial reform in theory have been recognized. Some of these arguments will subsequently be judged to be irrelevant or mistaken, but they are nonetheless real barriers to financial reform and especially so until they have been adequately examined. Moreover, those arguments against financial reform which are judged to be essentially correct must be confronted directly by the proponents of reform and weighed against the benefits of reform if the barriers to the reform of rural financial markets are ever to be overcome.

## Viability of Financial Institutions

The first argument against putting into practice a program of financial reform in spite of the potential benefits is that it will lead to the bankruptcy of many financial institutions and thereby seriously disrupt the economy. As previously indicated, the key element in a program of financial reform is raising interest rates to levels that approximate those which would be determined in competitive markets, and this may entail substantial increases in interest rates, especially in countries which have been experiencing high rates of inflation. The primary role of most financial institutions is to issue liabilities which are short term (e.g., demand and savings deposits) and to hold assets which are relatively long term.1/ After interest rates have been raised or permitted to rise to competitive levels in a program of financial reform, financial institutions with this typical structure of assets and liabilities are likely to find themselves facing serious difficulties. On one hand, they must almost immediately pay higher competitive rates of interest on their short-term liabilities in order to retain deposits and avoid a liquidity crisis. On the other hand, they cannot expect to charge higher interest rates on their long-term loans until these investments mature, so that they face potentially large losses, and even bankruptcy, depending on the extent of the increase in interest rates and the exact structure of their assets and liabilities.

Mathieson has proposed a solution to this problem of implementing a program of financial reform while at the same time avoiding bankruptcy for a significant portion

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1/ See Gurley and Shaw on the process of financial intermediation.

of financial institutions. In his model government policy makers have three objectives: to reduce the rate of inflation, to expand the real size of the financial sector in order to improve the allocation of resources and increase the rate of economic growth (which is the essence of a program of financial reform), and to maintain some minimum amount of profit for the financial institutions that would otherwise be threatened with bankruptcy by a substantial increase in interest rates. These policy makers also have three instruments to achieve their objectives: a ceiling interest rate on loans, a ceiling interest rate on deposits, and the rate of monetary expansion. Mathieson then uses optimal control theory to solve this problem and finds the optimal paths for monetary expansion, the loan ceiling rate, and the deposit ceiling rate. As is typical in the solution of such optimal control problems, there are two distinct phases in the optimal behavior of the policy instruments. In the first phase, there are relatively large discrete changes in the three instruments, as the rate of monetary expansion is reduced below its long-run steady state value while both the loan and deposit ceiling rates are raised above their long-run steady state levels. In the second phase, all three policy instruments gradually approach their long-run steady state values, but only after reversing direction because of their overshooting in the first phase.

It is not the purpose of the present paper to question Mathieson's formulation or solution of his model, but rather to ask what relevance this exercise has for policy makers in developing countries who may be considering the implementation of programs of financial reform. The solution suggested by optimal control theory is likely to have very little intuitive appeal for these policy makers. Recommendations which involve complex paths of overshooting and readjustment for policy instruments are unlikely to appear convincing to policy makers in developing countries, particularly since basing policies on optimal control solutions has made little headway with policy makers even in the advanced countries. In fact, such recommendations may well convince policy makers in developing countries that it is impossibly complex to implement a successful program of financial reform and thereby tip the balance against reform. Is the technical adviser who advocates financial reform thus left with an impossible task, or are there other approaches which can achieve financial reform without bankrupting a significant portion of financial institutions?

Mathieson (pp. 11 - 12) himself mentions two other possible solutions to this problem, but he dismisses each of these. First, a program of government loans could rescue financial institutions threatened with bankruptcy, but this might cause the monetary authority to lose control over the money supply. Second, a tax-subsidy scheme could transfer resources from other sectors of the economy to the threatened financial institutions, but this is rejected as having higher administrative costs than the optimal control policy of interest rate adjustment. However, before such alternative approaches are completely dismissed it would be worthwhile to know under exactly what circumstances the monetary authority would lose control over the money supply or what the relevant administrative costs are under different tax-subsidy schemes.

One particular tax-subsidy scheme seems especially appealing for reasons of allocation, equity, and administrative costs, that is, to raise interest rates on outstanding loans. Such a policy would not only remove the source of the threat to financial institutions but would also immediately remove the subsidy still accruing to the recipients of loans with interest rates well below the competitive equilibrium. Against such a policy it might be argued that this would breach the sanctity of contracts, but loan contracts in some developing countries allow for the subsequent adjustment of interest rates, and in other developing countries there are precedents for the *ex post* adjustment of interest rates, contracts notwithstanding, especially in situations involving indexation for inflation.[2/]

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2/ The question of the burden placed on borrowers by the upward adjustment of interest rates on outstanding loans will be discussed below in the context of the third argument against successfully implementing a program of financial reform.

There is a final reason, and perhaps the most important one, for not viewing the bankruptcy of financial institutions as a serious barrier to financial reform which required complex remedies. Most financial institutions in developing countries simply do not have a substantial proportion of their assets committed to long-term loans and investments on which the interest rates cannot be adjusted. In fact, one of the main complaints about finance in developing countries is that it is virtually all very short-term. In the case of agricultural credit, medium- and long-term loans to farmers are typically supported by (or more than supported by) long-term loans from international lending institutions and not by short-term deposits. Housing finance is the only sector in which long-term loans generally predominate, but even here the financial institutions in developing countries tend to rely heavily on long-term sources of funds and on deposits which may seem to be short-term but which are in fact compulsory.

Second Best

The second argument against implementing a program of financial reform is based on the theory of the second best. Given the pervasive distortions which are often said to be the essence of a less developed economy, it is not at all certain that removing some distortions in financial markets by raising interest rates to their equilibrium levels, while leaving undisturbed the distortions in other markets, will in fact make an economy better off. This argument has been made most forcefully for the maintenance of preferential low interest rates for the agricultural sector in order to compensate for other distortions which place the agricultural sector at a disadvantage and which cannot easily be removed.3/ Such arguments appear to leave the proponents of financial reform in developing countries with two options, neither of which is very attractive: (1) to recommend a program of wholesale reform covering all aspects of the entire economy; or (2) to carry out a detailed general equilibrium analysis of the economy in order to demonstrate that the economy will indeed be better off with a reform that covers only financial markets.

It is not the purpose of the present paper to argue that the theory of the second best is incorrect, but rather to argue that its warnings against partial reforms are not generally applicable for financial market reform in developing countries. The specific case to be examined here is the elimination of preferential low interest rates for the agricultural sector because, as indicated above, the strongest arguments have been made for the maintenance of this financial-market distortion in order to compensate the agricultural sector for other distortions which cannot

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3/ See, for example, Lizano.

readily be removed. The distortions most frequently mentioned which place the agricultural sector at a disadvantage are government policies which turn the terms of trade against agriculture. Prices of food and other primary products are kept low in order to keep costs low in the industrial sector, while prices of manufactured inputs into agriculture are kept high in order to encourage domestic industrial production. Such distortions are especially evident in the international trade policies of developing countries, as tariffs on manufactured goods raise the costs of imported agricultural inputs or force the agricultural sector to purchase inferior domestically-produced inputs, while these same tariffs result in an overvalued exchange rate which implicitly taxes agricultural exports. In addition to these policy distortions, it is said that the lack of appropriate infrastructure and noncompetitive conditions in marketing further raise the prices of inputs for farmers and reduce the prices received at the farm for agricultural output.

To these distortions which affect the prices of agricultural inputs and outputs can be added a variety of other problems facing the agricultural sector which are thought by many to be distortions deserving compensation through preferential low interest rates. The development and dissemination of appropriate technology for the agricultural sector, and especially for small farmers, involves significant externalities and may also involve an inefficient government bureaucracy in many developing countries. Rural inhabitants frequently face a disproportionate lack of infrastructure in such fields as education, health, and transportation, and this lack not only makes life in rural areas less agreeable but also raises the costs of productive activities in these areas. There is finally a distortion which applies directly to financial markets in rural areas, and this is the high costs that lenders incur in attempting to obtain reliable information about the probable repayment characteristics of potential borrowers, particularly when lender procedures are based on prior experience in urban situations and have not yet been adapted to rural circumstances.

It would be nice to be able to think that these distortions could be overcome, or at least ameliorated, by the simple expedient of requiring that loans to the agricultural sector be made at low interest rates, and without the necessity of confronting each of these distortions directly. The main problem with the view that preferential low interest rates can compensate the agricultural sector for these distortions, and consequently that a program of financial reform would not make the agricultural sector and the economy in general better off, is that it neglects the essential fact that credit is fungible.4/

To begin, it is necessary to note that there are two aspects to compensating the agricultural sector: income distribution and resource allocation. It can readily be shown that preferential low interest rates for the agricultural sector do not improve the distribution of income according to most notions of equity. Although the distribution of income is indeed biased away from the agricultural sector by the distortions discussed above, it is the wealthy farmers who receive the lion's share of the benefits from preferential low interest rates. Most farmers and other rural inhabitants in developing countries receive no credit whatsoever at preferential low interest rates, and even in developing countries such as Costa Rica, which is often cited for its wide distribution of agricultural credit, the distribution of credit is highly skewed toward large loans to large farmers.5/ Moreover, it is likely (although no definitive statistics are available) that the wealthy, including large farmers, hold a relatively small proportion of their wealth in the form of financial assets on which interest rates are currently controlled at low levels but would be raised to

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4/ See Von Pischke and Adams on fungibility.

5/ See Vogel on credit distribution.

higher levels or freed entirely under a program of financial reform.

Because of the essential fungibility of credit, preferential low interest rates for the agricultural sector also fail to redirect the allocation of resources in favor of the agricultural sector. Preferential low interest rates do not change the technologies available to farmers, nor the lack of infrastructure which raises costs, nor the prices paid by farmers for inputs and received for output. Hence, the relative profitability of agricultural and non-agricultural undertakings is left unchanged, as is the relative attractiveness of different activities within the agricultural sector. There is, however, one exception in that the price of capital is reduced for individuals with access to credit at preferential low interest rates, and these individuals are thereby encouraged to select more capital intensive activities and to select more capital intensive technologies for those activities which would have been undertaken even without preferential low interest rates. Whether such a capital intensive bias helps to direct more resources to the agricultural sector is unclear, but such a bias certainly does not improve the demand for labor in developing countries, most of which are experiencing widespread unemployment.

Opponents of reform for rural financial markets may, however, object that their policies include not only preferential low interest rates but also a larger volume of credit for the agricultural sector. This, they argue, will surely direct more resources to the agricultural sector, but here is precisely where the essential fungibility of credit cannot be overlooked. Credit provides a general command over resources and cannot be effectively tied to the production of particular goods, the purchase of particular inputs, or the use of particular technologies. As indicated above, credit at preferential low interest rates does not basically change the relative attractiveness of different activities, and to expect that farmers will significantly redirect their activities when offered more credit at preferential low interest rates is to expect farmers to behave irrationally (in the face of mounting evidence that farmers, and even small traditional farmers, are quite rational).

Concrete examples of fungibility can readily be found. Diversion of loans to other than prescribed uses by farmers in developing countries is widespread and has not been overcome by even the most diligent (and costly) program of supervision.[6/]

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6/ See Lipton on the supervision of agricultural loans.

More subtle and more pervasive is the case in which the farmer presents the lender with his most attractive undertaking, one which would have been carried out even if a loan were not received, and then uses the additional resources obtained with the loan for some unspecified activity. Such behavior is likely to be especially prevalent for large farmers in developing countries who obtain the lion's share of agricultural credit and who most often have a variety of activities outside the agricultural sector.

One distortion which places the agricultural sector at a disadvantage has not yet been discussed, and this is the distortion which applies directly to financial markets in rural areas: the high costs of obtaining information about potential borrowers until lenders adapt their procedures to rural circumstances. An argument, not based on the theory of the second best, can be made that lenders should be subsidized to cover some of the cost of serving rural clients until the necessary expertise has been acquired through learning by doing. This, however, suggests preferential low interest rates not for borrowers in the agricultural sector but rather for lenders. It can also be argued that preferential low interest rates for agricultural borrowers and increasing the volume of credit for the agricultural sector are contradictory policies in that preferential low interest rates for agricultural borrowers, other things being equal, encourage lenders to make less credit available for the agricultural sector and more for other activities. The theory of the second best, widespread distortions against agriculture in developing countries notwithstanding, does not provide a good reason for continuing policies of preferential low interest rates and failing to implement a program of rural financial market reform.

Short-Run Losses

The third argument against implementing a program of financial reform ironically grows out of some of the most forceful arguments in favor of reform. McKinnon (pp. 105-111) argues convincingly in a section entitled "Financial Reform with Tears" that the costs of a traditional stabilization program can be avoided when a program of financial reform is instead used to confront an inflationary situation. In a traditional stabilization program, monetary expansion, and hence credit, is curtailed in order to combat inflation. This often not only has the intended impact of reducing aggregate demand, but also has the unintended result of reducing aggregate supply because the availability of credit for working capital and other productive necessities is curtailed. Depending on the reduction in demand relative to the reduction in supply, little or no headway may be made against inflation, so that the major result of a traditional stabilization program is an immediate and sharp reduction in output which cannot long be tolerated by elected (or even by unelected) officials.

The alternative remedy for inflation proposed by McKinnon is a program of financial reform in which interest rates are raised substantially to make them at least positive in real terms if not at the levels that would prevail under competitive conditions. Higher interest rates on deposits would divert demand away from goods, especially inflation hedges, and thus help to alleviate inflationary pressures. The greater demand for financial assets would permit an expansion, rather than a contraction, of credit so that more working capital would be available. At the same time, higher interest rates on loans would improve the allocation of resources by diverting credit away from activities with low rates of return and toward those with high returns. Thus, inflation would be reduced and the economy would actually expand at a more rapid pace, thereby avoiding the initial reduction in output which has undermined so many traditional stabilization programs.

The ability of a program of financial reform to accellerate economic growth depends on the extent to which saving can be increased and the allocation of resources can be improved. Unfortunately, there is little clear evidence that higher interest rates increase saving, although there is considerable evidence that higher interest rates on deposits do cause a greater proportion of savings to be held as deposits with financial intermediaries. This represents an improvement in resource allocation to the extent that financial intermediaries can channel resources more efficiently from these savers to potential investors. However, the main source of the improvement in resource allocation is the higher interest rates on loans which direct scarce savings toward investment projects with higher yields, primarily by reducting the demand for credit by entrepreneurs with lower-yielding potential investments. Thus, anticipations of increased economic growth from a program of financial reform depend largely on the extent to which resources have been misallocated and, in particular, on the extent to which savings have been allocated to the wrong investment projects.

Herein lies the paradox which may present a serious barrier to implementing a successful program of financial reform. Potential long-run benefits from reform will be great to the extent that savings are currently flowing into investment projects with low yields, but this implies that there is a substantial stock of fixed capital which will be inappropriate for the economy after the reform has been carried out. This stock of inappropriate fixed capital is currently being made profitable by the subsidy implicit in the low interest rates on loans, but unlike the working capital in McKinnon's model of financial reform it cannot readily be reallocated to more profitable activities precisely because it is fixed capital. This means that a significant portion of the fixed capital in a pre-reform economy will suddenly, with the advent of a program of financial reform, be written down substantially in value, perhaps even to its salvage value if it ceases to have an economic use in the post-reform economy. If, as suggested under the first argument against financial reform, interest rates are raised on outstanding loans, then the burden on the inappropriate stock of fixed capital will be greater, and the ensuing disruptions and adjustments will take place more rapidly.

The disruptions which McKinnon had hoped to avoid by his program of "financial reform without tears" will be of two sorts: economic and political. The economic disruptions will take the form of write downs in the value of fixed capital resulting in possible bankruptcies and in the realignment of numerous economic enterprises. It is difficult to see how a loss of output in the short run can be avoided during this period of adjustment, McKinnon notwithstanding, even though the benefits of improved resource allocation following from the financial reform will be vastly greater in the long run. The political disruptions will depend on the power of those who are losing their access to the credit subsidy stemming from the low interest rates on current loans and whose fixed capital is being written down substantially in value. It may be that this group can be partially compensated (bought off) into acquiescence in a manner which is less harmful to resource allocation than the current credit subsidy. Such mechanisms have sometimes been proposed to compensate those who lose the implicit subsidy from tariffs in the process of international trade reform, and the discussion of the last argument against financial reform will examine some of these parallels between international trade reform and financial reform. In any event, the greater the attractiveness of financial reform because of its potential long-run benefits in improved resource allocation, the more likely there are to be serious short-run disruptions which will pose a barrier to implementing the reform.

Reform of International Trade Policies

The fourth argument against the possibility of putting a successful program of financial reform into practice is that it cannot be separated from other reforms, not in the sense of the theory of the second best discussed above, but rather in that there is a direct link between financial reforms and these other reforms. In particular, it has been argued that financial reform cannot be separated from a developing country's reform of its international economic policies, and in fact the books by both McKinnon and Shaw devote considerable attention to questions of international economic policy reforms.

The necessary connection between financial reform and international economic policy reform can be seen most clearly by initially considering a situation in which a developing country has achieved, at least temporarily, a stable exchange rate and a reasonable equilibrium in its balance of payments. Into this situation a financial reform is introduced with its higher interest rates on loans and deposits. This will make the return on domestic financial assets higher relative to the return on foreign assets and will bring about an inflow of capital as both foreigners and the residents of the developing country shift out of foreign assets and into domestic financial assets. In addition, the higher interest rates on domestic loans will make it more attractive for both foreigners and the residents of the developing country who previously had access to low interest rate domestic loans to borrow in foreign financial markets, and this will further supplement the capital inflow.

This inflow of capital into a developing country which previously had a stable exchange rate and equilibrium in its balance of payments is usually viewed as a good thing, at least initially, because it represents a potential increase in the country's foreign exchange reserves. Under a system of fixed exchange rates, which is typical for most developing countries, this potential increase is translated into an actual increase in foreign exchange reserves, which in turn means an increase in the stock of high-powered money. The monetary authority in the developing country which is undergoing financial reform under a system of fixed exchange rates is thus left with the unpleasant alternatives of either restricting domestic credit to offset the increase in foreign exchange reserves or permitting a multiple increase in the money supply. Restricting domestic credit is likely to lead to the reduction in output that the financial reform was trying (à la McKinnon) to avoid, while permitting the increase in the money supply will lead to more inflation and thereby undo the increase in real interest rates that the financial reform was trying to accomplish.

Another alternative is to offset directly the potential increase in foreign exchange reserves by changing the exchange rate, that is, by increasing the value of the domestic currency relative to foreign currencies. This, of course, happens automatically for those few developing countries which operate under systems of flexible, rather than fixed, exchange rates. The problem with this soulution is that it curtails potential exports and encourages imports, both of which are likely to be at variance with the policy objectives of the developing country and which will certainly be unpopular with producers for export and with domestic producers of import substitutes.[7/]

The last alternative to be considered here is a liberalization of imports in order to offset the potential increase in international reserves or appreciation of the exchange rate in a developing country undergoing a program of financial reform. Such a liberalization would involve the reduction of tariffs on goods which are thought to be overly protected and an elimination of quotas and other nontariff barriers against imports. However, these policies of import liberalization are likely to be strongly opposed by the domestic producers of import substitutes who are threatened with increased competition, and this is precisely the same group which was undoubtedly important, if not instrumental, in initiating protection against imports. The politics of international trade policy has long been a popular subject, and in fact this literature is almost as abundant as the literature on the pros and cons of protection itself.[8/]

A second connection between financial reform and the reform of international trade policies, and the final point

7/ The problems which confronted Korea in attempting to coordinate a program of financial reform with the reform of its international economic policies are described in McKinnon, pp. 164 - 166, and in Shaw, pp. 210 - 212.

8/ See Ray for a recent example of work integrating the politics and economics of protection.

to be considered in the present paper, is the relevance of this literature on international reform for understanding the politics of financial reform. There is a very close parallel between the gainers and losers from a program of financial reform and the gainers and losers from changes in tariffs and other forms of protection. A point frequently made about the politics of international trade reform is that the gainers from reduced protection are a widely dispersed group, consumers, each of whom benefits relatively little from reform, whereas the losers are a relatively small and cohesive group, producers of import substitues, each of whom may lose a great deal from reduced protection. In the case of financial reform, the gainers are likewise a widely dispersed group, the holders of deposits on which interest rates have been kept at low levels, each of whom is likely to gain relatively little through higher interest rates, whereas the losers who have to this point been benefiting from subsidized low interest rates on their loans are likely to be a relatively small group of economically important individuals, if the agricultural credit situation in developing countries is at all indicative. Thus, in both financial and international trade reform, although the gains outweigh the losses in the aggregate, the losers are likely to have the incentive and the position to oppose reform strongly and effectively.

The parallel between financial reform and international trade reform can easily be extended further. For example, the villains who are supposed to be overcome by tariff protection and by subsidized low interest rates can readily be identified in both cases. In international trade it is the foreign producers who depend for their advantage either on advanced technology or on cheap labor according to the perspective of those desiring protection, while in financial markets it is the banks, and especially the private moneylenders. Why do these villains fail to support reform? The foreign producers are busy buying out domestic producers or setting up their own facilities behind the tariff and nontariff barriers, while the banks are content to earn profits in a regulated rather than a competitive environment, and the private moneylenders are also not eager to encourage competition and prefer to talk only about their nonmoneylending business activities. Other likely sources of opposition to financial reform are the government officials and loan officers who see the distribution of credit at subsidized low interest rates as a possible source of patronage. Similar behavior in the international trade context may explain why quotas are so often favored over tariffs in situations in which tariffs are clearly superior on economic grounds: quotas provide more direct control over patronage.[9/]

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9/ See Lipton for a more radical view of the creation and distribution of credit subsidies.

## Conclusions

Among the main conclusions to emerge from an examination of these four arguments against the possibility of implementing a successful program of financial reform are that the first two arguments should not represent serious barriers to reform. Widespread bankruptcy of financial institutions is not likely to occur in a developing country undergoing a program of financial reform because most financial institutions in developing countries do simply not have the structure of assets and liabilities which would expose them to the threat of bankruptcy in the event that interest rates were raised substantially. For those financial institutions which are in fact threatened with bankruptcy, there are a number of alternative remedies that could be considered, with perhaps the most attractive option being to raise interest rates on outstanding loans. The theory of the second best also fails to produce a convincing argument against implementing a program of financial reform. Even granting the existence of serious distortions in most developing countries, and in particular distortions which place the agricultural sector at a disadvantage, does not mean that a program of preferential low interest rates can compensate for these distortions. In fact, because of the fungibility of credit and the concentration of agricultural credit in large loans to large farmers, preferential low interest rates are uniquely ill-suited to compensate for distortions in other markets.

The last two arguments against financial reform provide both political and economic reasons to be concerned about the possibility of implementing a successful program of financial reform. To the extent that a program of financial reform promises a significant long-run increase in economic growth because of a substantial current misallocation of resources, it also promises a significant disruption of output in the short-run. In addition, those who see their fixed capital being written down substantially in value because of a program of financial reform can be expected to provide a strong political opposition to reform. The connection in developing countries between financial reform and the reform of international trade policies is especially important for at least two reasons. First, because of capital flows, it is difficult to conceive of a successful program of financial reform without some measure of international trade reform. Second, because of the close political parallels between financial reform and international trade reform, the abundant literature on the politics of trade reform may provide some insights into the possibility of implementing financial reforms and, in particular, what forms of compensation and other devices might minimize the opposition to financial reform. More detailed study of countries, such as Taiwan and Chile, which have carried out programs of financial reform may also indicate how the opposition to reform can be overcome. In Chile, for example, the economic chaos toward the end of the Allende regime may ironically have removed effective opposition to the military government's financial reforms.

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